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No. 95-1641

In the Supreme Court of the United States

OCTOBER TERM, 1995

MARY BRABSON, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether prejudgment interest on damages awarded in a personal injury suit is excluded from gross income under Section 104(a)(2) of the Internal Revenue Code as "damages received * * * on account of personal injuries or sickness" (26 U.S.C. 104(a)(2)).

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-17) is reported at 73 F.3d 1040. The opinion of the district court (Pet. App. 18-43) is reported at 859 F. Supp. 1360.

JURISDICTION

The judgment of the court of appeals was entered on January 11, 1996. The petition for a writ of certiorari was filed on April 10, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. On July 15, 1981, petitioners were injured by an explosion caused by a gas leak in their home. Petitioners sued the City of Colorado Springs, Stratmoor Hills Water District, and Stratmoor Hills Sanitation District and obtained a judgment for $1,502,150.02 for personal injuries, $97,840.98 for property damage, and $341,159.10 in prejudgment interest pursuant to Colo. Rev. Stat. § 13-21-101(1) (1987) (Pet. App. 2, 19).

In 1986, while the case was on appeal, Stratmoor Hills Water District and Stratmoor Hills Sanitation District settled with petitioners for a lump sum payment of $155,948.87. In November 1986, the Colorado Court of Appeals affirmed the judgment. The City of Colorado Springs, the remaining defendant, filed a petition for a writ of certiorari in the Colorado Supreme Court. The writ was initially granted but, after oral argument was heard, the writ was denied as having been improvidently granted. In June 1988, the City of Colorado Springs satisfied the judgment with a payment of $2,888,414.06, which included $370,723.12 in statutory prejudgment interest (Pet. App. 2-3, 20).

2. Petitioners did not include the prejudgment interest on their 1988 federal income tax returns. They took the position that such interest constituted "damages received * * * on account of personal injuries" within the meaning of Internal Revenue Code Section 104(a)(2). The Internal Revenue Service included the prejudgment interest payments in petitioners' gross income and asserted tax deficiencies against them (Pet. App. 3, 20). Petitioners paid the asserted deficiencies and brought suit for a refund.

The district court held that prejudgment interest awarded pursuant to Colo. Rev. Stat. § 13-21-101(1)

(1987) is excludable from income under Section 104(a)(2) of the Internal Revenue Code. The court noted that the underlying state court suit sounded in tort and that the prejudgment interest was received as a result of that suit (Pet. App. 24). The court stated that prejudgment interest is awarded under Colorado law as an element of damages that compensates for the injuries that have been suffered. The court concluded that prejudgment interest is therefore excludable from income under Section 104(a)(2) (Pet. App. 26-29).

3. The court of appeals reversed (Pet. App. 1-17). The court noted that, under this Court's decision in *Commissioner* v. *Schleier*, 115 S.Ct. 2159 (1995), two requirements must be met for a recovery to be excluded from gross income under Section 104(a)(2): "First, the taxpayer must demonstrate that the underlying cause of action giving rise to the recovery is 'based upon tort or tort-type rights'; and second, the taxpayer must show that the damages were received 'on account of personal injuries or sickness'" (Pet. App. 7, quoting *Commissioner* v. *Schleier*, 115 S. Ct. 2167). The court of appeals stated that prejudgment interest is awarded under Colorado law as compensation for the lost time value of money (Pet. App. 10) and that "the taxability of this interest is purely a question of federal law" (*ibid.*).

The court explained (Pet. App. 10-12) that neither the text nor history of Section 104(a)(2) or of the Treasury's related regulation (26 C.F.R. 1.104-1(c)) authoritatively resolves whether prejudgment interest represents "damages received * * * on account of personal injuries." The court, however, identified several factors that were instructive in answering this question. First, the court noted that

prejudgment interest historically has been awarded to compensate for pecuniary or economic, rather than personal, harms and is thus not part of the basic "concept of damages for personal injuries" expressed in Section 104(a)(2) (Pet. App. 15). Second, the court noted that prejudgment interest is awarded for the delay in recovering damages, rather than for the injuries themselves, and is thus "not linked to the injury in the same direct way as traditional tort remedies" (Pet. App. 16). Noting "that exclusions from income must be narrowly construed" (Pet. App. 16) citations and internal quotation marks omitted)), the court concluded that prejudgment interest does not constitute "damages received * * * on account of personal injuries" within the meaning of Section 104(a)(2) (Pet. App. 17).

ARGUMENT

Petitioners contend (i) that the decision of the court of appeals conflicts with this Court's decision in *Commissioner* v. *Schleier*, (ii) that the court of appeals failed to defer to the state law characterization of prejudgment interest in Colorado as "damages" and (iii) that the petition should be granted because this case presents the same issues presented in *O'Gilvie* v. *United States*, 66 F.3d 1550 (10th Cir. 1995), cert. granted, Nos. 95-966 & 95-977 (Mar. 25, 1996). Each of these contentions, however, is incorrect. Further review is therefore not warranted.

1. a. Gross income is broadly defined to mean "all income from whatever source derived" (26 U.S.C. 61(a)). In particular, all forms of "interest" are specifically included in gross income. 26 U.S.C. 61(a)(4). Under Section 104(a)(2) of the Internal Revenue Code, however, "the amount of any damages received * * *

on account of personal injuries or sickness" may be excluded from gross income (26 U.S.C. 104(a)(2)). As an exclusion from income, Section 104(a)(2) is to be narrowly construed. See, *e.g.*, *United States* v. *Centennial Savings Bank*, 499 U.S. 573, 583-584 (1991); *Commissioner* v. *Jacobson*, 336 U.S. 28, 49 (1949). Two express criteria must be satisfied under the statute for a taxpayer to qualify for this exclusion: (i) the amount received must constitute "damages" and (ii) the damages must be received "on account of" a personal injury or sickness. 26 U.S.C. 104(a)(2).

As the court of appeals concluded in this case (Pet. App. 16), even if prejudgment interest were thought to constitute "damages," interest is not received "on account of" a personal injury or sickness. Instead, it is awarded on account of the delays in obtaining awards of damages for personal injury (*ibid.*). As the court of appeals noted, prejudgment interest is not a traditional remedy for personal injury and is awarded on account of claim-processing delays, rather than on account of the personal injury itself. Recognizing that the exclusion from income established in Section 104(a)(2) is to be narrowly construed, appellate courts have consistently concluded that prejudgment interest is not to be treated as compensation for the underlying injury itself under Section 104(a)(2). See Pet. App. 14-17; *Kovacs* v. *Commissioner*, 25 F.3d 1048 (6th Cir.) (Table), cert. denied, 115 S.Ct. 424 (1994), aff'g 100 T.C. 124 (1993).

b. Petitioners contend (Pet. 14-16) that the court of appeals failed to give proper deference to the state-law characterization of prejudgment interest as "damages." That contention, however, misconceives the appropriate role of state law in determining federal income tax liability.

While a State may characterize prejudgment interest as a component of "damages" (see Pet. App. 9), that does not control the determination required under federal law whether such an award represents "damages * * * on account of personal injury" within the meaning of Section 104(a)(2) of the Internal Revenue Code. In enacting federal tax statutes, "Congress establishes its own criteria and the state law may control only when the federal taxing act by express language or necessary implication makes its operation dependent upon state law." *Lyeth* v. *Hoey*, 305 U.S. 188, 194 (1938); accord *Helvering* v. *Stuart*, 317 U.S. 154, 162 (1942); *Morgan* v. *Commissioner*, 309 U.S. 78, 81 (1940).

The mere fact that a State designates prejudgment interest to be an element of "damages" under state law does not resolve the question under federal law whether such recoveries are excluded from income by Section 104(a)(2) (see Pet. App. 8-10). That question of federal law was answered correctly by the court of appeals and there is no conflict among the circuits to warrant further review.[1]

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[1] The court of appeals correctly described the function of prejudgment interest as compensation for delays in awards of damages rather than for the personal injury itself. Pet. App. 16; see *Allstate Insurance Co.* v. *Starke*, 797 P.2d 14, 19 (Colo. 1990) (prejudgment interest is "awarded to compensate the plaintiff for the time value of the award eventually obtained against the tortfeasor"). Although prejudgment interest is "compensatory," it compensates for the lost time value of money and not for any personal injury. Contrary to petitioners' contention (Pet. 11), the decision of the court of appeals thus correctly acknowledged the "compensatory" role of prejudgment interest.

2. The decision in this case does not conflict with the decision of this Court in *Commissioner* v. *Schleier*, *supra*. The issue in *Schleier* was whether backpay and liquidated damages recovered under the Age Discrimination in Employment Act of 1967, 29 U.S.C. 621 *et seq.*, are excludable from gross income under Section 104(a)(2). The taxpayer argued in *Schleier* that he need only prove that the underlying claim is based on "tort or tort type rights" for any recovery on that claim to be excludable under Section 104(a)(2). The Court rejected the taxpayer's argument, however, noting that the plain language of Section 104(a)(2) establishes two requirements: (i) the taxpayer must demonstrate that the underlying cause of action giving rise to the recovery is "based upon tort or tort type rights"; and (ii) the taxpayer must show that the damages were received "on account of personal injuries or sickness." 115 S.Ct. at 2167.

The court of appeals expressly adopted and unequivocally applied the analysis of *Schleier* in this case. The court noted that "*Schleier* makes clear that all elements of a damage award received by a taxpayer must satisfy these two prongs" (Pet. App. 7). The court concluded that the award of prejudgment interest in this case—like the award of backpay or liquidated damages in *Schleier*—fails to satisfy the requirement that it be received "on account of" the personal injury (*id.* at 16 (noting the lack of a "direct link between the injury and the remedial relief")). Petitoners' contention (Pet. 12) that the decision in this case conflicts with *Schleier* is thus wholly unsupported.

3. Petitioners claim (Pet. 10) that this case presents "the same basic questions" presented in

O'Gilvie v. *United States*, cert. granted, Nos. 95-966 & 95-977 (Mar. 25, 1996). But the only similarity between the cases is that they arise under the same statute. That is not a sufficient basis for certiorari to be granted in this case.

O'Gilvie presents the question whether a punitive damages award received in a personal injury suit is excludable from income under Section 104(a)(2) as damages received "on account of" personal injuries. The Tenth Circuit held in *O'Gilvie* that punitive damages received in a personal injury suit are not excludable from gross income under Section 104(a)(2). In so holding, the court reached the same conclusion that has been reached on that issue by four other circuits. *O'Gilvie* v. *United States*, 66 F.3d at 1556, 1560. See *Wesson* v. *United States*, 48 F.3d 894 (5th Cir. 1995); *Hawkins* v. *United States*, 30 F.3d 1077 (9th Cir. 1994), cert. denied, 115 S.Ct. 2576 (1995); *Reese* v. *United States*, 24 F.3d 228 (Fed. Cir. 1994); *Commissioner* v. *Miller*, 914 F.2d 586 (4th Cir. 1990). This Court granted certiorari in *O'Gilvie* to resolve a conflict that exists between these five circuits and the Sixth Circuit, which reached a contrary conclusion on that same question in *Horton* v. *United States*, 33 F.3d 625, 630 (6th Cir. 1994).[2]

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[2] In *O'Gilvie*, the court of appeals applied the reasoning of this Court in *Schleier* that Section 104(a)(2) requires *both* that the underlying cause of action giving rise to the recovery be based upon tort or tort type rights *and* that the damages be received on account of personal injury or sickness. 66 F.3d at 1557. The court noted that the phrase "on account of," as used in Section 104(a)(2), was ambiguous. Interpreted broadly, "on account of" could mean that any damages received in a personal injury suit were excludable. On the other hand, the phrase could be read to require a causal connection between the

In *O'Gilvie*, the question presented concerns the relationship between punitive damages and personal injury—not the relationship between prejudgment interest and personal injury. See note 2, *supra*. Prejudgment interest serves a purpose and function entirely different from punitive damages. Prejudgment interest serves to compensate for the delay in payment between the time of the injury and the rendering of judgment. A punitive damage award, on the other hand, serves to punish and deter wrongdoing. A determination as to the relationship between punitive damages and personal injury will therefore not resolve the question of the relationship between prejudgment interest and personal injury. There is, accordingly, no need to hold the present petition pending the Court's decision in *O'Gilvie*.

Because there is no conflict among the circuits on the question presented in this case, and because the question presented here is both factually and analytically distinct from the question presented in *O'Gilvie*, further review is not warranted in this case.

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damages received and the personal injury sustained. 66 F.3d at 1558. Because punitive awards are made "on account of" the tortfeasor's malice and not "on account of" the personal injury itself, such awards would not be excluded from income under the latter understanding of the statute. See, *e.g.*, *Commissioner* v. *Miller*, 914 F.2d at 589-590. Based upon the "default rule" of statutory construction that exclusions from income must be narrowly construed, the court held in *O'Gilvie* that the phrase "on account of" must be understood to require a causal connection between the damages received and the personal injury sustained. Since punitive damages are awarded to punish and deter, rather than to compensate for an injury, the court held in *O'Gilvie* that punitive damages are not excludable from income under Section 104(a)(2). 66 F.3d at 1559-1560.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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